Revenue Ruling 2008-1

U.S. Dollar Denominated Derivative Contract Treated As Euro Denominated Debt

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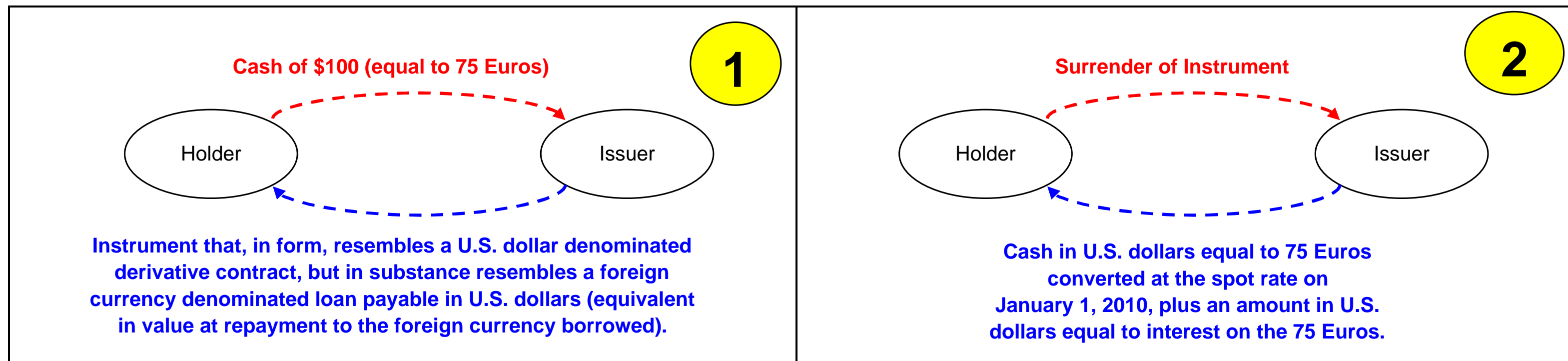

Assume that on January 1, 2007, the spot rate of exchange of U.S. dollars for Euros was $1 = €0.75. On January 1, 2007, Holder delivered $100 to Issuer in exchange for the Issuer's obligation (the "Instrument") to deliver to Holder, on January 1, 2010, the U.S. dollar equivalent of an amount of Euros (the "U.S. Dollar Equivalent Amount"). The U.S. Dollar Equivalent Amount is determinable on January 1, 2010, and is the sum of the following amounts translated into U.S. dollars at the spot rate on January 1, 2010: (i) €75, and (ii) an amount of Euros calculated by reference to a compound stated rate of return applied to €75 from January 1, 2007, until January 1, 2010. The compound stated rate of return is the excess of a rate based on euro interest rates over a rate labeled as a "fee" for the benefit of the Issuer. (The U.S. Dollar Equivalent Amount to be paid by Issuer to Holder on January 1, 2010, may also be determined by reference to a mathematical formula that generates the same substantive effect as the methodology described above.) Holder and Issuer expect that Issuer will pay the U.S. Dollar Equivalent Amount on January 1, 2010. The legal remedies provided in the Instrument are not materially different than legal remedies associated with instruments that are debt for federal tax purposes. The U.S. dollar is the functional currency of Holder. There is a significant possibility that the U.S. Dollar Equivalent Amount payable by Issuer to Holder on January 1, 2010, may be significantly less than $100.

An instrument that requires payments to be made in a foreign currency (that is, nonfunctional currency) can be debt for U.S. federal income tax purposes. See, e.g., section 988(c)(1)(B)(i) of the Internal Revenue Code. Thus, although nonfunctional currency is considered to be "property" for U.S. federal tax purposes, it is treated like money for purposes of determining the amount and timing of interest that accrues on debt. See Reg. 1.988-2(b)(2). Section 988 and regulations thereunder also provide that the acquisition of a debt instrument or becoming the obligor under a debt instrument is a section 988 transaction if the amount that a taxpayer is entitled to receive or is required to pay is determined by reference to the value of a nonfunctional currency. See, e.g., section 988(c)(1); Reg. 1.988-1(a)(1) (flush language) and 1.988-2(b)(2)(i)(B)(2). These provisions indicate that a financial instrument all the payments of which are determined by reference to a single currency can be debt, notwithstanding the fact that (i) all actual payments due under the instrument are made in a different payment currency, and (ii) the amount of the different payment currency that the issuer pays at maturity may be less than the amount of the different payment currency that was initially advanced. Indeed, section 988 was adopted, in part, to negate suggestions "that U.S. tax consequences can be manipulated by arranging to repay a foreign-currency denominated loan in U.S. dollars equivalent in value at repayment to the foreign currency borrowed."

The Instrument, in form, resembles a U.S. dollar denominated derivative contract in which the Holder prepays its obligations under the contract, and is entitled to receive a return based exclusively on the value of property at maturity. (See Notice 2008-2) However, the U.S. Dollar Equivalent Amount that is payable at maturity by the Issuer under the terms of the Instrument is determined exclusively by reference to (i) the U.S. dollar value of the Euros at issuance and at maturity, and (ii) market interest rates in respect of the euro. At inception (on January 1, 2007), the Holder delivers the U.S. dollar equivalent of €75, and at maturity (on January 1, 2010) the Issuer is required to pay the U.S. dollar equivalent of €75, plus the U.S. dollar value at maturity of a return based on euro interest rates. The fact that intervening currency fluctuations may cause the amount of U.S. dollars that Holder receives at maturity (on January 1, 2010) to be less than the amount of U.S. dollars that the Holder paid for the Instrument (on January 1, 2007) does not affect the characterization of the Instrument as debt, which is based on an analysis of payments with respect to the euro. The Issuer's translation of U.S. dollars into Euros (on January 1, 2007) and Euros into U.S. dollars (on January 1, 2010) is not relevant to the Instrument's characterization. For U.S. federal tax purposes, the Instrument is euro-denominated indebtedness of Issuer. This result is not affected if the Instrument is (i) privately offered, (ii) publicly offered, or (iii) traded on an exchange.

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